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## **Trade and Labor Standards: A Trade Economist's View**

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## Trade and Labor Standards: A Trade Economist's View

Arvind Panagariya

### 1 Introduction

The issue of linking trade and labor standards must be seen against the background that the demands for it has come from the developed countries, principally the United States. In turn there are two important sources of pressure within the United States: ethically driven groups that would like to see the fate of the workers around the world improve and protectionist lobbies in the developed countries that fear competition from the cheaper labor-intensive imports from the poor, labor-abundant countries. The frustration with the slow progress in achieving their goals has led the ethically driven groups to seek alliance with the protectionist interests who are evidently more resourceful. In turn, the protectionist interests have found the moral cover provided by the alliance convenient. The outcome has been a focus on trade sanctions as a *morally* justified instrument of promoting labor standards in the poor countries. The latest manifestation of this focus has been in the debate over the Central American Free Trade Agreement (CAFTA) in the United States. The U.S. labor lobbies are arguing that CAFTA must be stopped because it will hurt the interests of the workers in the U.S. and will not do nearly enough to improve the fate of those in the five countries in Central America and Dominican Republic (for example, see *Washington Post*, June 20, 2005).

In this paper, I argue that while the objective of advancing labor standards deserves support, the protectionist pressures that aim to link labor rights to market access should be actively resisted. The poor countries are already paying for the high protection now provided to the interests of the corporations through very high standard of

intellectual property under the Uruguay Round Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). The countries cannot be asked to pay yet again to protect the interests of developed country labor lobbies through a link between labor standards and market access. Two wrongs do make a right.

The argument for linking trade and labor standards is being rested partly on the claims that a “consensus” now exists on a set of labor standards imbedded in the so-called core ILO conventions and all we are lacking is an instrument to enforce those Conventions. I begin in Section 2 by challenging this claim, arguing that the consensus among nations is limited to the principles and aspirations underlying the ILO core conventions. Few countries agree on the enforcement of the specific standards and norms as stated in the ILO conventions. In Sections 3, I critically examine the case for linking trade and labor standards. I first consider the ethical and moral case for promoting higher labor standards through trade sanctions. I then examine the “willingness to pay” argument, questioning validity of the evidence presented to-date and its interpretation. I also address the fair-trade argument for the harmonization of standards internationally, which comes from the protectionist angle. Finally, I offer an efficiency argument against linking trade and labor standards arguing that such a link may sometimes lead to perverse outcomes. In Section 4, I outline some measures that are available to improve labor standards without resorting to the threat of trade sanctions. In Section 5, I conclude the paper.

## **2 Consensus: Aspiration versus Norms and Standards and Trade-Labor Link**

The proponents of the trade-labor link often speak in terms of a “consensus” on the promotion of the labor standards in four areas that they often dub as “core” standards:

forced labor, rights of workers to organize and bargain collectively, non-discrimination and child labor. While the proponents do not do this, it is important to examine the claims of the consensus at three different levels: aspirations and sentiments; specific standards and norms to be enforced; and the use of trade sanctions.

In terms of the aspirations and sentiments, the claims of consensus are broadly justified. With rare exceptions, modern nation states would agree that they aspire to build societies that are free of forced or child labor, give workers the right to associate freely and bargain collectively and do not discriminate among workers based on their religion, race or sex. At the personal level, even parents that send their children to work would agree that they would prefer to send them to schools if they could.

But once we get past the aspirations and sentiments and begin to define the precise standards and norms in each of the so-called core areas, differences emerge. The proponents of the trade-labor link nevertheless argue that a consensus exists in terms of the standards and norms contained in the eight specific ILO conventions covering the four so-called “core” areas:

- Forced Labor Convention, 1930 (No. 29) and the Abolition of Forced Labor Convention 1957 (No. 105) on conditions governing forced labor;
- Freedom of Association and Protection of the Right to Organize Convention, 1948 (No. 87), Right to Organize and Collective Bargaining Convention, 1949 (No. 98) on the worker right to unionize and bargain collectively;
- Equal Remuneration Convention, 1951 (No. 100) and Discrimination (Employment and Occupation) Convention, 1958 (No. 111) on the standards governing non-discrimination; and

- Minimum Age Convention, 1973 (No. 138) and the Convention on the Worst Forms of Child Labor, 1999 (C182) on the rules against child labor.

Contrary to the claim by the Northern groups, there is no agreement among countries on the detailed provisions contained in these conventions. For starters, many developed countries are yet to ratify several of these conventions. The most striking example is the United States, which has ratified only two of the above eight conventions to-date: the Abolition of Forced Labor Convention 1957 (No. 105) and the Convention on the Worst Forms of Child Labor (C182). Thus, the U.S. is yet to ratify either of the conventions on each of the right to unionize and bargain collectively and on non-discrimination. It has also abstained from the ratification of the important Minimum Age Convention (C138) on child labor, and the Forced Labor Convention (C29). In each of these areas, the U.S. domestic laws and practice fall short of the requirements of the relevant conventions. For example, the ILO Minimum Age Convention (C138) has uniform standards in farm and non-farm employment. In the U.S., under its Fair Labor Standards Act (FLSA), the standards vary across the two types of employment. Moreover, along many dimensions, the U.S. standards fall short of those stipulated in the ILO Minimum Age Convention.

Ironically, if one goes by the ratification of the core ILO conventions, most of the Central American countries and Dominican Republic, which have just signed the Free Trade Area (FTA) agreement with the United States, would seem to have higher standards in the so-called core areas than the latter. Thus, according to the ILO website, as of December 31, 1996, Costa Rica, Guatemala, Honduras and Nicaragua had ratified *all* seven original core conventions, El Salvador had signed all but three (C87, C98 and

C100) and Dominican Republic all but one (C138). The latter ratifies C138 in 1999 so that among the recent FTA signatories, only El Salvador falls short of ratifying all original core ILO conventions. All of the signatories have also ratified Convention 182, which was introduced in 1999. Yet, the opposition to CAFTA by the U.S. labor lobbies on the ground that these countries lack acceptable labor standards suggests that they do not view the ratification of the ILO Conventions as indicative of the actual acceptance of the standards and norms.

When confronted with the evidence that the record of the countries in ratifying the ILO conventions is highly variable, the proponents of the view that a consensus on the acceptable standards exists fall back on the 1998 ILO Declaration on the Fundamental Principles and Rights at Work as evidence of binding commitments to the core ILO conventions by all ILO members. Yet, the Declaration commits the ILO member states only to *respect and promote principles and rights* in the so-called core areas rather than *enforcement of the specific standards and norms* in the Conventions. Indeed, if the Declaration actually represented a binding commitment to the eight conventions identified above, the United States will itself be in its violation since its domestic labor laws in areas of child labor, freedom of association and the effective recognition of the right to collective bargaining and the elimination of discrimination in respect of employment and occupation do not fully conform to the core ILO conventions.

Indeed, it is not clear that even the ratification of the ILO Conventions by a country necessarily reflects its willingness to enforce the standards and norms in them. The U.S. practice is to ratify the international conventions only *after* its domestic laws are in compliance with provisions in the conventions. As such, given the norms and

standards imbedded in its domestic laws, the U.S. has only ratified the ILO Conventions 105 and 182. If other countries do not follow this same practice, there remains the issue whether the fact of the ratification of the ILO Conventions can then trump the existing domestic laws. Going by the labor provisions of the U.S. FTAs, the domestic laws seem to take precedence over any ILO Conventions that the country may have ratified: the FTA agreements oblige the signatories to enforce only their domestic laws in the core areas and make no reference to the enforcement of the provisions in the conventions ratified by the countries.

Once we come down to the domestic laws, however, the claims of a consensus on the standards and norms becomes even less persuasive. According to the specialists I have consulted, the norms and standards embedded in the laws of various Latin American countries are quite diverse. Even across the Central American countries, these standards vary by wide margins so that though they have signed the same agreement with the United States, their actual obligations with respect to labor norms are quite different.

Because the governments may choose different levels of enforcement, even the harmonization of laws need not result in the identity of the standards and norms across countries. Thus, suppose Costa Rica and Nicaragua, both members of the Central American Free Trade Agreement (CAFTA), have the same child labor laws but one has enforced them more vigorously. Obviously, the two countries do actually adhere to the same standards and norms. The problem seems even more complex when seen in the context of the August 2000 report entitled *Unfair Advantage: Workers' Freedom of Association in the United States under International Human Rights Standards* (August 31, 2000) by the Human Rights Watch, which offers a stunning indictment of both the



existing laws governing worker rights and their enforcement in the United States. Based on the first-hand evidence gathered from field studies in a large number of states, the report concludes as follows regarding the enforcement of laws on the worker rights on the freedom of association and collective bargaining: "Many workers who try to form and join trade unions to bargain with their employers are spied on, harassed, pressured, threatened, suspended, fired, deported or otherwise victimized in reprisal for their exercise of the right to freedom of association." The report goes on: "The cases studied in this report are not isolated exceptions in an otherwise benign environment for workers' freedom of association." Given this state of enforcement in the United States, any claims to the consensus on the effective standards and norms around the ILO core conventions even when countries have similar laws in the core areas is fictional rather than real.

Finally, in the Latin American context, the proponents of trade-labor link also claim that a consensus now exists on the positive role the trade sanctions can play in enforcing higher labor standards and that the issue is no longer whether or not but how to use this instrument. This is clearly the conclusion an innocent reader is likely to draw from the following description of the state of the play offered by Polaski (2004):

"Parallel to the multilateral trade negotiations and institutions, the United States and other countries have negotiated a series of bilateral and regional trade agreements in recent years that go beyond the scope of the multilateral GATT and WTO accords. Since 1993, the United States has included labor provisions in all bilateral and regional free trade agreements it has negotiated, as well as a bilateral textile agreement it negotiated with Cambodia. Canada and Chile have also included labor provisions in at least some of their bilateral trade agreements.

Brazil, Argentina, Uruguay and Paraguay—countries in the southern cone of South America—have included labor commitments and institutions as part of the architecture of the Mercosur common market. However, these countries have not directly included labor rights in their common trade agreement. As a result of all of these initiatives, there is a growing body of experience and a growing variety of approaches on *how to link labor rights with trade*.” [Emphasis added.]

The clear suggestion here is that the major players in Latin America—Brazil, Argentina, Mexico and Chile—are now all wedded to the idea of linking trade and labor standards. Yet, nothing could be farther from the truth. Every single agreement signed by any Latin American country that links trade and labor standards has been exclusively with and in response to the demands by the United States and Canada. The linked agreements, thus, include (i) the North American Agreement on Labor Cooperation (NAALC), a side agreement to the North American Free Trade Agreement (NAFTA) to which Mexico is a signatory; (ii) the Canada-Chile Agreement on Labor Cooperation (CCALC) similar to the NAALC; (iii) the Chile-U.S. FTA that binds Chile to enforcing the existing labor laws; and (iv) the U.S.-Central America-Dominican Republic agreement with similar provisions, signed after the Polaski (2004) paper had been written.

What do we then make of the MERCOSUR example cited by Polaski? It turns out that the MERCOSUR labor standards provisions are not just outside of the core customs union agreement, they are also devoid of any link to trade. As such the MERCOSUR model of the promotion of labor standards has nothing in common with the U.S model. In this respect, it is useful to quote Motta Veiga and Lengyel (2003, p. 13) from their painstakingly careful account of the labor rights as promoted within the

context of the MERCOSUR, “MERCOSUR countries have systematically and officially rejected the idea of linking trade and labor norms while supporting proposals for strengthening the ILO and its conventions.” They go on to state later in the paper (Motta Veiga and Lengyel 2003, p.15),

“The Treaty of Asuncion, which laid the ground for the establishment of MERCOSUR, neither included social issues in its provisions nor provided a specific space in its institutional architecture for addressing them. This situation was amended in 1991 due to different stakeholders’ complaints (mainly labor unions) about the overly economic and trade biases of the arrangement. The so-called Working Sub-Group 11 (renamed Working Sub-Group 10 on “Labor relations, employment and social security” since 1995) was thus created by the executive authority of MERCOSUR (the Common Market Group) to deal with labor affairs. In line with the overall spirit of the sub-regional agreement, this institutional change did not involve, either formally or in practice, the surrendering of national authority to any MERCOSUR instance to broker or supervise labor standards.”

Finally, it deserves noting that the developing country objections to any trade-labor link have also been expressed forcefully in the WTO negotiations. The U.S. and EU have regularly voiced such demands in the WTO forums and the developing countries have regularly opposed them with one voice and without exception. Brazil, in particular, has been at the forefront of the battle against the introduction of any trade-labor link in the WTO. Thus, when evaluated against the actual evidence, the claims of a consensus around the ILO core standards are nothing short of disingenuous.

### 3 A Critical Examination of the Northern Demands for the Standards<sup>1</sup>

Let us now consider some of the key arguments made in support of the Northern demands for higher standards in the South and for generating the supply of the latter through trade-labor link. Each of these arguments appears plausible at first blush but turns out to be treacherous upon closer examination.

#### 3.1 *The Ethical-Moral Arguments for the Trade-Labor Link*

In simple terms, the moral argument for trade-labor link from the viewpoint of the Northern proponents is that if a country has chosen to adhere to higher labor standards within its national boundaries, it should have the moral right to suspend trade with another country that does not adhere to equally high labor standards. For instance, if the United States subscribes to values that do not admit child labor and has itself outlawed the practice, it should also have the right to suspend imports made by child labor in other countries.

A serious problem with this argument is that when the United States chooses to outlaw child labor from its territory, it also chooses to pay the costs associated with the higher standard by sacrificing the output produced by potential child workers and by committing resources to educational facilities for the latter. But when it asks other countries to also abandon the practice *because it will help promote a value held dear by its own citizenry*, the cost in terms of the output foregone and additional resources spent on education is borne by the trading partners. If these costs were trivial, there would be no substantive reason for a dispute. But the costs are not trivial. For example, according

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<sup>1</sup> This section is heavily drawn on Panagariya (2003), which was itself heavily influenced by

to a study done by Consumer Utility and Trust Company (CUTS), an NGO based in India, it will cost anywhere between \$12 billion to \$18 billion per annum in India alone to send all existing child workers to schools. It is unlikely that the United States and other developed countries that want India to end child labor would offer to bear even a tiny fraction of this cost.

Indeed, this argument is on a very slippery slope. If one accepts it, one should be equally willing to accept the right of the other countries to suspend imports from the United States because the latter continues to practice the capital punishment. The countries could plausibly argue that just as the persistence of child labor in the partner countries offends the sensibilities of the U.S. consumers, the continuance of the capital punishment offends their consumers. Indeed, a country such as India could even defend trade sanctions on the ground that the U.S. does not provide the same degree of job security to the workers in the large factories that it does.

The defenders of the argument sometimes respond that the values in question are not the U.S. values but those shared universally. But as I have already discussed above, in terms of specific standards to be enforced, the set of shared values vastly narrower than the standards sought by the Northern advocates. The broader set of values is shared only at the level of aspirations, with wide differences separating the countries on the precise pace at which these aspirations are to be translated into action and the paths to be taken. Using the example of child labor example introduced above, in abstract, most parents are likely to share the value that child labor is “wrong”. But when forced to choose between child starvation and child labor, most of them will also choose child labor. In the less

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Bhagwati (1995) and Panagariya (2001).

extreme form, countries have much greater tolerance for child labor on the farm than industry, as evidenced by the weaker child labor laws in agriculture than industry in the United States. Even within industry, there is less tolerance for child labor in hazardous activities. This is most dramatically illustrated by the rapid ratification by the countries of the ILO Conventions 182 while the Convention 138 has languished. Again, in the United States, no one questions the morality of children distributing newspapers in the neighborhood or working as babysitters.

The consensus is equally gray when it comes to the worker rights. For instance, workers are frequently represented on the boards of the firms in Europe but not the United States. Indeed, with labor unions being absent from most factories in the United States, it is not even clear how this could be accomplished there. Likewise, the laws against strikes are much stricter in some of the rich countries (for example, secondary boycotts are proscribed in the United States) than in some of the developing countries such as India.

Rodrik (1997) offers a subtler defense of the “preservation of moral values” argument, which appears persuasive at first blush but turns out to be inconsistent upon closer examination. Thus, suppose there is a U.S. corporation, which must find a cheaper source of supply of some of its labor-intensive components if it is to survive. Suppose further that it has two options. Under the first option, it can outsource the components to a local Honduran firm that runs a sweatshop operation. Under the second option, it can open a domestic sweatshop at the Mexican border and employ the same Hondurans as migrant workers. The costs of production, the wages received by Hondurans workers (net of migrations costs) and working conditions are identical under the two cases.

Therefore, if one approves of one option, he must approve of the other option as well.

Rodrik notes, however, that this is not so. To quote him (Rodrik 1997, p. 34),

“Interestingly, the vast majority of the economists who have no difficulty with the outsourcing example would also accept that it is not good public policy to relax labor standards for migrant workers to the point of allowing sweatshop conditions. Clearly, there is an inconsistency between these two positions. There seems to be a greater coherence in the behavior of the lay public, which reacts with equal outrage to the two versions of the parable—outsourcing versus migration—than in the perception of the economists.”

On the surface, this appears to be a compelling critique of the position taken by the opponents of trade sanctions against countries with low labor standards. Yet, upon closer examination, contrary to Rodrik’s contention, it is the position of the ‘lay public’ that is logically inconsistent and the view of the ‘vast majority of the economists’ that is consistent. Thus, when the ‘lay public’ shows outrage against the poor treatment of migrant workers, it wants them to be treated at par with U.S. workers with the cost of such treatment falling on the corporation and hence the U.S. economy. But when the ‘lay public’ shows outrage against sweatshops in Honduras, it wants trade sanctions that place the burden of upholding their moral values on the Hondurans! Logical consistency would require that the ‘lay public’ be willing to offer the Honduran government the cost of bringing the working conditions in Honduras to the U.S. level as well.

Likewise, the apparent contradiction in the position of the ‘vast majority of economists’ is resolved once we recognize that when foreigners come in the midst of post-Renaissance societies, especially the United States, the local population begins to

view them as one of their own. The willingness to confer the same rights on migrant workers as those available to local workers is an outcome of this empathy. Moreover, the acceptance of sweatshops abroad is a vote not against the rights and well being of the workers employed therein but against trade sanctions that will otherwise visit them.

Indeed, the position attributed by Rodrik to the 'lay public' looks more coherent and understandable when considered from the purely selfish viewpoint of the United States labor. Within the framework of his parable, weaker labor standards in Honduras mean greater competition through trade in labor-intensive industries in the United States. Likewise, permitting sweatshop conditions for migrant labor on the U.S. soil gives greater incentive to U.S. firms to employ the latter. Both policies put pressure on the wages paid to local workers.

### *3.2 The Willingness to Pay Argument*

While rejecting trade sanctions as an instrument to promote labor standards, Freeman (2002) nevertheless goes on to build the case for the legitimacy of the Northern demands for higher labor standards in the South on the ground that "people care about the work conditions associated with the goods they purchase." He offers evidence from four different sources that in his view indicate the willingness of the Northern buyers to pay for the standards they demand: surveys in which many respondents offer to pay higher prices for products produced under 'good' conditions; an experiment in which half or less consumers chose to buy socks made under good labor conditions despite higher prices; fall in the prices of stocks of the companies subject to anti-sweatshop or anti-child-labor campaign; and the petitions by the shareholders to the management to adopt higher labor standards.



The first problem with the evidence based on surveys and experiments reported by Freeman is that the precise phrasing of the question they ask can readily influence the response of the ethically and morally driven consumers. For example, Freeman (2002, pp. 13-14) suggests the following approach to measuring willingness of consumers to pay for the standards they demand:

“A better way to find out whether people are willing to pay extra for a product made under good labor conditions is to perform an experiment by offering to sell a product to consumers with different associated conditions of production. Imagine two piles of T-shirts in a retail store. *One says, Made Under Good Conditions meeting world labor standards. The second says, Made by child labor in Sleazo's Sweatshop.* At equal prices, how many consumers would buy the Good Conditions T-shirt rather than the Child Labor T-shirt'? At a 50 cent premium, how many would make that choice'? At a \$1.00, \$2.00, etc?’ [Emphasis added.]

An experiment along these lines was run by a University of Michigan team that placed two piles of socks next to each other in a store, with a statement that those in one pile were made under good working conditions. The price of socks in the pile made under good conditions was successively varied from 0% to 40% more than those in the other pile. The study found that at the same price, half of the consumers chose the socks made under the unspecified conditions. Thus, the average consumer did not care about standards. Moreover, increases in price for the socks made under good conditions reduced that proportion of purchasers from half to approximately one third. Even the largest increase in the premium left some consumers buying the socks made under good conditions. Freeman (2002, p. 14) draws the following inference from the study:

“The implication is that there exists a niche market for socks made under good conditions that could garner a quarter to a third of the socks market and generate enough additional revenue to improve wages and conditions for workers, but that those socks would not sweep the market. Since socks are not a visible branded item about which there have been anti-sweatshop campaigns, and the experiment was not associated with a campaign, the results may not carry over to some other experimental design.”

As one would expect of a careful scholar, Freeman does not draw a sweeping conclusion from the experiment and is, in fact, careful to qualify that the results may not carry over to some other experimental design. But the problem is even more serious. It is possible that many consumers do not care to look at the price when picking socks. Therefore, even if the price had been higher in one pile and no indication of a difference between the conditions under which they were produced, some consumers would end up picking the socks from the pile with the higher price. Freeman is wrong to count all those paying the higher price among those willing to pay something extra for better conditions. Some of the consumers may well be paying extra because they never looked at the price difference in the two piles.

But this is a minor quibble. The more serious quibble has to do with precisely how the question is phrased. Thus, suppose we were to alter the experiment as follows. We place two piles of socks as above in a retail store and post the following statement in front of one pile: “These socks were produced in a poor country, with children contributing to their manufacture so that their families could escape starvation.” We now vary the price of socks in the pile made by children from 0% to 40% more than those in

the other pile. I will dare speculate that at least as many buyers that stayed with the “good standards” pile will now stay with the pile of socks manufactured with child labor.

The second problem with the general argument made by Freeman on the basis of the survey and experiment data is that a general support for “good conditions” cannot readily be translated into specific standards and norms. Take, for example, the survey evidence cited by him (Freeman 2002, p. 12) according to which “An average 85 percent of respondents in the Marymount survey said they would pay \$1 more for a \$20 item if they could be assured that it was made under good conditions.” What is meant by “good conditions” in this statement? Does it refer to the ILO core labor standards, the U.S. labor standards, the European labor standards or the Argentine standards?

Third, even if we come to an agreement on the definition, we must know whether the \$20 item currently produced under lower labor standards can be actually produced for \$21 under the “good conditions.” If, for example, the cost under those “good” conditions would actually rise to \$30, the desired standard cannot be supplied at the price offered. The respondents are then looking for a “bargain” in the standards that simply does not exist. The implication is that the willingness to pay a positive price is not the same thing as the willingness to pay the full marginal cost of switching from the current standards to the “good conditions.”

Fourth, if “good conditions” in the respondents’ minds are synonymous with the U.S. standards, they already have the choice to buy them: similar goods with the “Made in U.S.A.” stamp. As such, one could argue that the niche market to which Freeman alludes in the context of the socks experiment by the University of Michigan study is already being exploited. One can also argue that in so far as the vast majority of the

consumers are concerned, by revealed preference, they are not willing to pay the higher cost of the U.S. labor standards since they are increasingly opting for the cheaper foreign-made goods.

If one rejects this argument, he must answer why the effective demand for “good standards” backed by the willingness to pay does not translate into supply in the market place? Normally, when the market fails to supply the product of a given standard for which demand exists, there is a market failure. For example, in the absence of regulation, oil companies would supply cheaper low-grade gasoline since neither they as sellers nor motorists as individual buyers take into account its adverse effect of the low-grade gasoline on the air quality. But if motorists as individual buyers of gasoline did care for the adverse effect of the low-grade gasoline on the environment, oil companies will readily supply the high-grade gasoline. Therefore, if one makes the argument that the buyers as individuals do care for higher labor standards, the market should supply them as, for example, through market-supplied socio-labels that identify the relevant labor practices.

To push the point a little further, consider the example used by Freeman (2002, p. 11) himself to provide motivation for why product standards might matter:

“Treating standards as part of the product parallels Adam Smith's and Alfred Marshall's analyses of compensating differentials. Marshall (1890) differentiated between the bricklayer who cares whether he works in a palace or in a sewer and the seller of bricks who doesn't care whether his bricks pave the palace or sewer. The bricklayer's concern creates compensating wage differentials in the job market: higher pay for sewer work. The consumer who cares about labor

standards consumes not only physical goods but also the work conditions associated with them. She is willing to pay higher prices for the goods produced under better conditions because she feels better knowing that the workers have decent conditions. This provides a financial margin for improving conditions or increasing wages in LDCs.”

Taking Marshall’s example at face value, a prospective employer wishing to hire the bricklayer to work in a sewer will have to pay a higher wage than the one wishing to hire him to work in a palace. You would require no intervention on behalf of the bricklayer hired to work in the sewer. Why then should an intervention be necessary on behalf of the consumer desiring a higher labor standard? If the willingness to pay exists (as in the case of the employer of the bricklayer in the sewer), the market should supply the standard. The argument offered by Freeman is at best incomplete and at worst flawed.

The evidence on the impact of working conditions relating to the product on the share prices is subject to similar criticisms. For example, if the share prices respond to the adverse publicity regarding the working conditions, the firms will take that into consideration when choosing the standards under which they choose to operate. After all, similar considerations apply to the standards (including those relating to the environment, for example) to which the firms adhere in the domestic arena. Furthermore, even if one accepts the argument, the relationship of the stock prices to the precise norms and standards is less clear. How far does the firm need to raise the standards to recover the fall in the price? More importantly, in so far as the rise in the standards must raise the costs of production and hence profitability, one needs to know whether the decline in the

stock price due to reduced profits will not offset any increase in the price directly resulting from the shareholder preference for the higher standards.

In the same vein, the evidence that in some cases the share holders have pressed the management to adopt better practices would not seem to require any additional action either. The market is functioning just as it should in these cases. From the evidence cited by Freeman, the pressure from shareholders has come mainly in the egregious cases in which near consensus exists as, for example, in the case of Unocal, which does business in Myanmar where forced labor is common. But such special cases hardly warrant the general conclusion that shareholders would run away en block from profit motive in favor of the U.S. labor standards.

### 3.3 *The Fair Trade Issue*

The protectionist (in contrast to ethical) argument for linking trade and labor standards is presented in the form of the “fair trade issue.” Freeman (2002), who is clearly sympathetic to the cause of the labor, dissects the argument in detail and rejects it. Since I reach the same conclusion, I will deal with the argument only briefly here and primarily from a trade economist’s perspective.

The argument made by the proponents of trade-labor link is that lower labor standards in developing countries give them “unfair” competitive advantage over their developed country counterparts, especially in the labor-intensive industries. Deep down, this is akin to the age-old pauper labor argument according to which rich country labor-intensive industries cannot compete against poor countries because the producers in the latter are able to get away with low wages. Traditionally, the argument has relied primarily on the existence of low wages in the labor-abundant countries as the source of

“unfair” advantage. In its current incarnation, the reach of the argument has been widened to include a whole host of labor standards among the sources of unfair advantage.

Trade economists have long argued that this argument is in direct conflict with the basic principle of comparative advantage. Virtually every textbook on international trade describes the pauper labor argument in terms of a misunderstanding of the fundamental principle of comparative advantage. The simple point is that high wage countries are perfectly capable of competing against low wage countries due to their higher productivity. What they cannot do is to compete against the latter in sectors in which they lack comparative advantage.

Indeed, if one accepts the “fair trade” argument, from the developing countries’ viewpoint, one could equally well argue that the developed countries enjoy huge “unfair” advantage over them in the capital-intensive products due to much superior technology and enormous stock of capital. Thus, for instance, if we were to conduct a survey in New Delhi on whether the superior access to technology and capital gave *developed* countries an unfair competitive advantage, almost all respondents will answer in the affirmative. And they will also overwhelmingly support provisions in the WTO that will require developed countries to share technology with developing countries at low or no cost. But does that make good economic sense? The very essence of the gains from trade is that due to differences in underlying fundamentals, countries differ in their abilities to produce different products. Developing countries have a comparative advantage in labor-intensive goods and developed countries in capital- and technology-intensive goods.

A slightly different twist to the fair trade argument is that trading freely with countries with lower labor standards may lead to a decline in one's own standards. This is the so-called "race to the bottom" argument. As commonly made, the argument states that competition for capital and jobs may lead countries to adopt ever-declining labor standards. Therefore, there is a need to set the labor standards cooperatively. While this theoretical possibility exists, its empirical relevance is quite suspect. There is little evidence that the United States and European Union have actually lowered their labor standards in response to increased competition from the labor-abundant countries.

### *3.4 The Efficiency Issue*

In assessing the appropriateness of making labor standards a part of the WTO or other trade agreements, two simple analytic points may be made. First, in general, optimal labor standards are not uniform over time or across countries either from the national or global welfare standpoint. The changes in marginal benefits and costs of labor standards as, for example, due to changes in income or productivity in "supplying" labor standards, cause optimal labor standards to vary over time as well as across nations.

For example, suppose we define the labor standard with respect to child labor in terms of the number of hours worked by children. The lower the number of hours worked the higher the standard. Suppose further that the households derive positive utility from adhering to a higher standard. Then, since the marginal utility of income declines as income increases, we will expect the optimal level of labor standard to rise as wages rise. This effect can be made even stronger by assuming that the income elasticity of demand for the standard exceeds unity. To the extent that countries may build these "optimal" standards into their laws, there is no presumption that the observed differences



in labor standards between two countries must imply deviations from optimal standards in at least one of them. Nor is there a case for the harmonization of labor standards internationally (or over time) on the ground that it promotes efficiency at the global or national level.

Second, the targeting literature, pioneered by Bhagwati and Ramaswami (1963) tells us that when an economy is in a sub-optimal equilibrium, the first best policy is to correct the underlying distortion at source. Once this is done, there is no need to intervene elsewhere in the economy. Thus, if the market happens to produce sub-optimal labor standards, we should correct this distortion directly rather than through an indirect instrument such as trade sanctions.

For instance, suppose child labor is the result of under-investment in education by the government. Parents would prefer to send their children to schools but there are not enough schools. Then, rather than leave the children to roam the streets, they choose to send them to work. In such a situation, the targeted solution to the problem is increased investment in schools. Trade sanctions that aim at child labor can in principle make matters worse by forcing children out of work and on to the streets. This is evidenced by the experience of Bangladesh in 1993 when merely the threat of U.S. sanctions led the terrified owners of garment factories in Dhaka to dismiss all children below age 16. According to an article by Jeremy Seabrook in the *Financial Times*, anecdotal evidence suggests that many of these children met a fate worse than in the factories, ending up in workshops and factories not producing for export, or as prostitutes and street vendors.

This outcome is reminiscent of the outcome of a tariff in the Harris-Todaro model of unemployment. In that model, the urban wage is rigidly fixed above the rural wage.

This leads rural workers to migrate to the city. But not all of them find employment in the city. The targeted solution to this problem is to remove the wage rigidity, which is often the result of a government policy in the first place. But if a tariff to protect the urban output is used instead, it may lead to such a large migration from rural areas that urban unemployment actually increases!

If the distortion is corrected at the source, free trade remains a welfare enhancing policy. Thus, in the Harris-Todaro model, once we remove the wage rigidity, free trade is restored as the best policy. Likewise, in the child labor example, the provision of schools eliminates any need for trade sanctions. Purely from an efficiency standpoint, a case cannot be made for linking trade and labor standards.

#### **4 The Problem Redefined and the Possible Solutions**

If genuine progress is to be made, it is important to first recognize that at the implementation and enforcement level, the “consensus” standards are quite far away from those specified in the so-called core ILO conventions. For example, in the area of child labor, the current boundary of “consensus” would seem to be defined by the standards in the ILO Convention 182 on the employment of children in the hazardous occupations. Here rapid progress can be made. On the other hand, there is no consensus on achieving the standards laid down in the ILO Convention 138 on the minimum working age in non-hazardous occupations within a short span of time. Here the goal should be to speed up the process of phasing out child labor without any illusions or pretensions that all countries will come into full compliance with the ILO Convention 138 any time soon. Likewise, the standards relating to worker safety and forced labor are more achievable in

the foreseeable future than those relating to the freedom of association, collective bargaining, employment guarantee and minimum wage.

If we are genuinely driven by ethical and moral considerations, we should also recognize that the trade-labor link would simply not achieve the desired goal. Such a link could at most (and, I may add, at a very high cost to the poor countries) improve the standards in the firms exporting their products while possibly making them worse in the rest of the economy. Only a very narrow and selfish interpretation of the ethical and moral argument leads one to targeting such an outcome.

Take, for example, child labor. Worldwide, only 5% of the working children are in the export industries. As such, trade agreements that require the absence of child labor would at most move these working children from the export industries to the import-competing or non-traded goods industries. I say at most because as long as the goods produced by children in the export industries are sold in the domestic market, they need not even move into other sectors. All the country has to do is to ensure that the firms that employ children sell their wares in the domestic market. In the same vein, trade agreements may promote the right to unionize and bargain collectively in the export industries but not beyond. Indeed, where trade agreements are bilateral or plurilateral rather than multilateral, the impact is even narrower since those agreements apply only to the trade among the member countries. All the member countries need to do is not export the products made under lower standards to the union partners.

Lest this may seem too pessimistic, let me quote from chapter 16 on the trade-labor link in the CAFTA agreement. Article 16.2, paragraph 1a of this chapter in the agreement says,

“A Party shall not fail to effectively enforce its labor laws, through a sustained or recurring course of action or inaction, in a manner *affecting trade between the Parties*, after the date of entry into force of this Agreement.” [Emphasis added.]

Thus, effectively, as long as the lack of enforcement of the domestic labor laws by a member country does not affect its *bilateral* exports to another CAFTA member country, the country does not risk the violation of its labor-standards commitments. In effect, the agreement even opens the door to *diverting* exports to a third country by weakening enforcement selectively. For example, as long as the goods containing child labor are exported to the outside countries (or sold at home), a member country will not be in violation of its CAFTA commitments.

This analysis suggests a two-track strategy. Where consensus exists as with the employment of children in the hazardous activities, worker safety and forced labor, a push can be made towards speedy progress. And the areas in which consensus is at the aspirations level, as for example on the minimum age norms in the ILO Convention 138, a longer term strategy has better chances of success. Among other things, the longer terms strategy must include rapid growth and spread of democracy, which are known to promote better labors standards. As for other instruments, we may consider the following:

#### *4.1 Making the ILO More Effective*

The proponents of trade sanctions have steadfastly argued that the ILO has no enforcement power. This argument can be easily overstated. To some degree, the weaknesses of the ILO are the result of deliberate policy choices whereby this institution has been starved for funds. The United States has provided minimal financial support to

it. The recent experience with the Convention on the Worst Forms of Child Labor (C182) would seem to suggest that on the standards on which countries are in agreement, ILO is able to help initiate action successfully. At the initiative of the United States, all 175 ILO members agreed to sign and implement the provisions of this convention. For countries such as India, this amounted to undertaking extra obligations including the enactment of new laws. Thus, when the conviction to translate certain values into action is truly shared and a major power such as the United States puts its weight behind it, ILO has been shown to generate action. In contrast, universal conviction to translate the values contained, for example, in the Minimum Age Convention, 1973 (No. 138) has been lacking. Labor lobbies are, thus, simply wrong to assert that ILO fails because it lacks enforcement power. Instead, its failure has more to do with a lack of consensus. Therefore, the natural course for ILO would seem to be to forge consensus and bring moral pressure on the countries. Here one could bring the experience of the Trade Policy Review Mechanism (TPRM) at the WTO to bear upon labor standards. Periodic reviews of labor practices in member countries could help build the necessary pressure to speed up their promotion symmetrically across developing and developed countries.

#### *4.2 Trade Liberalization*

Trade restrictions in developed countries are by far the highest on products exported by developing countries: textiles and clothing, footwear, fisheries and agricultural products.<sup>2</sup> If these countries are sincere in their wish to see higher standards in developing countries, they should begin by opening their markets to labor intensive

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<sup>2</sup> See Panagariya (1999) for detailed evidence.

goods. They cannot take the high moral ground and then make developing countries pay for it. Charity must begin at home. It goes without saying that developing countries must likewise liberalize their own trade if they want labor-intensive exports to grow and workers to benefit from it.

It deserves emphasizing that trade liberalization has the potential to improve labor standards for two reasons. First, in so far as it will expand the labor-intensive sectors in the developing countries, it will raise the wages and other standards there. Second, trade liberalization is an essential ingredient in generating faster growth, which in turn stimulates higher labor standards. Both steps in the second argument require elaboration.

On the first step, it is remarkable that many NGOs and even scholars see the reduction in trade barriers in the rich countries as an important step towards promoting growth in the poor countries but at the same time remain skeptical of the need for the removal of the barriers in the poor countries themselves as being important for such growth. Thus, for example, Freeman (2002, p. 6) essentially rejects the view that the removal of developing country trade barriers helps these countries grow faster. To quote him, “While orthodox policies have a certain logic inside simple trade and macro models, whether they are right for real economies is less clear. Cross-country evidence shows that policy measures relating to openness such as tariffs and trade barriers have little link to growth.” Nevertheless, when it comes to the developed country barriers to developing country exports, Freeman (2002, p. 21) sees their removal as the most important contribution developed countries could make to the betterment of the worker conditions in the developing countries: “Assume that you could choose between a) eliminating all barriers to LDC products in advanced countries and substantially reducing the debt burden of the poorest countries; or b) improving information and monitoring on labor standards in LDCs. If your goal was to make the lives of LDC workers

better, you would choose a). Elimination of tariffs and other barriers to LDCs, particularly in agriculture, and reduction of huge debt burdens almost certainly can create more good for more people than improved labor standards for workers in export sectors or even more broadly.”<sup>3</sup> This view also runs through the writings of other scholars such as Dani Rodrik and Joseph Stiglitz, publications of the NGOs such as the Oxfam and Christian Aid, and research reports of international institutions such as the UNCTAD and UNIDO.

Yet, seen from one perspective, the two positions are logically inconsistent with one another. The liberalization by the developed countries is seen to help promote growth in the developing countries through improved prospects for their exports. But the liberalization by the developing countries accomplishes much the same objective by making exports more attractive relative to the sales in the domestic market. To make the argument forcefully, think of the extreme case in which the developed countries adopted complete free trade but developing countries impose prohibitive barriers. Developing countries will achieve no export growth in this case. Opening only the developed country door is insufficient for exports to materialize; the developing country door must also be opened if the goods are to exit the country. This fact is amply demonstrated by the relative experiences of South Korea and India during the 1960s and 1970s. As developed countries opened their markets, South Korea could take advantage of it because it too switched to an outward-oriented strategy. India, which chose a highly inward-looking strategy, failed to achieve the same success.

In Panagariya (2004), I have systematically documented that in the last fifty years, virtually no developing countries have achieved sustained rapid growth without either

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<sup>3</sup> Freeman uses the acronym LDC to refer to the developing countries (or “less developed countries”) as a whole rather than the narrower group of the Least Developed Countries as it is

low or declining level of protection. No doubt, countries such as China and India have achieved high levels of growth in the 1980s and 1990s with protection levels that were still high. But they accomplished this while bringing the protection levels down. And their trade during this period grew far more rapidly than in the decades of high or rising protection and low growth.

High growth, which eventually leads to high standards of living, is also known to bring with it high labor standards. The countries in the Far East that achieved high per-capita incomes also rapidly eliminated child labor. Again, India failed to grow rapidly for several decades and also failed to make much progress in reducing child labor. With growth having picked up in recent years, the prospects for an improvement in labor standards including child labor look much better.

Openness in general contributes to higher living standards in a more direct way as well. In many countries, the process of globalization has brought about democracy, which *ceteris paribus* brings better labor standards. In countries such as South Korea, democracy has helped promote the conditions for workers in general. Likewise, even with low levels of income the worker rights for organized labor in the democratic India have been not just good but perhaps better than in many developed countries along some dimensions.

#### 4.3 *Socio-Labels*

I have argued in the paper that it is not altogether clear that the market is failing to provide the consumers in the developed countries products made under the desired

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used currently.



working conditions. In most product categories, equivalent developed country products are available. Therefore, the issue of the socio-labels would seem to be relevant only when the equivalent products made in countries with acceptable labor standards are unavailable. In one case in this category, carpets, the market has produced the socio-labels such as the Rugmark that informs the buyer on the absence of child labor.

The absence of a product from a country that has acceptable labor standards does not automatically establish the case for a government-sanctioned socio-label, however. The reason is that the effective demand that will support the price compatible with the desired standards may still not exist. Only in cases that a market failure can be identified an economically justified case for the government-sanctioned socio-label can be made.

Strategically, the socio-labels may nevertheless be a useful instrument of diffusing the pressures for the trade-labor link. One area in which this may be especially true is corporate social responsibility. Labels such as SA 8000 may be effective in reassuring the public that corporations provide the standards that are being demanded by the public in their products. But even here the right approach would be to have a multiplicity of socio-labels with corporations given the freedom to choose among them based on the pressures they feel from their shareholders.

#### *4.4 Education*

One of the key conditions necessary to reduce child labor is the provision of schools and education. Poverty being the key reason for child labor in many parts of India, even the provision of mid-day meals at schools has helped draw children out of the labor force. In so far as this is a very resource-intensive activity, developed countries can play a major role in it by providing more aid funds to the poorer countries.

#### 4.5 *Developed Country Standards*

Finally, if we are going to persuade developing countries of ethical and moral considerations rather than protectionist motives driving the agenda, it is important that demands be made symmetrically of the developed countries to enforce and perhaps upgrade their labor laws. We simply assume that all is well in the developed countries. But as I noted earlier citing the August 2000 report by the Human Rights Watch entitled *Unfair Advantage: Workers' Freedom of Association in the United States under International Human Rights Standards* (August 31, 2000), this is not the case. The text referred to the failure in the United States in the area of enforcement. But the report also points out serious deficiencies in the laws themselves. Thus, the report states: "Millions of workers are expressly barred from the law's protection of the right to organize. The US legal doctrine allowing employers to permanently replace workers who exercise the right to strike effectively nullifies the right. Mutual support among workers and unions recognized in most of the world as legitimate expressions of solidarity is harshly proscribed under the US law as illegal secondary boycotts."

Given these gaps in the laws and their poor enforcement in the rich countries, it is important for developed countries to be sensitive to improvements in their own labor standards. Otherwise developing countries will see the demands for higher labor standards by them as reflecting exclusively protectionist tendencies. In this context, it may be noted if trade-labor link is established in the trade agreements and the developing countries then begin to challenge the enforcement of the laws by developed countries, trade wars may be the outcome. Enlightening the public on this dimension may help defuse the pressures for the link in the first place.

## **5 Conclusions**

In this paper, I have discussed the scope of the consensus on the labor standards to be enforced and the possible link between them and market access. I have endeavored to show that the claims of consensus on the standards and norms in the so-called “core” labor conventions of the ILO are without empirical basis. I have also shown that the claims by some analysts of a consensus to enforce higher labor standards through trade conditionality border on being disingenuous since the only agreement with such a link are those pushed by and involving the United States and Canada. To-date, there is not a single agreement exclusively involving developing countries that links trade and labor standards.

I have also offered a critical examination of the arguments made by various lobbies to justify their demands of higher labor standards from the developing countries and for linking these demands to trade. I have shown that the evidence supporting the demands is not always compelling and that the case for the trade-labor link made on either moral grounds or protectionist grounds fails to stand up to close scrutiny. Finally, I have argued that the best course for promoting higher standards is to adopt a two-track strategy: in areas such as worst forms of child labor, worker safety and forced labor where consensus on the standards and norms to be adopted exists, a speedy implementation and in areas where consensus is limited to the level of aspirations and sentiments, a more phased approach. As for the instrumentality, I have suggested strengthening the ILO, socio-labels, faster expansion of education and trade liberalization in both developed and developing countries. In this respect, the WTO Doha Round offers an unusual opportunity. The member countries will do more to promote labor standards

world wide if they achieved worldwide free trade by 2015 in at least industrial products and substantial liberalization in agriculture as a part of the Doha Round negotiations.

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